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IN THE

Supreme Court of the United States

OCTOBER TERM, 1953

NO. 665

W. L. KANN and STELLA H. KANN, Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE.

ESTATE OF GUSTAVE H. KANN, Deceased, MARY P. KANN, W. L. KANN and FERDINAND T. WEIL, Executors, Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

Petitioners pray that a Writ of Certiorari issue to review the Judgments (R. 151, 152) entered in the above-entitled cases on December 31, 1953, by the United States Court of Appeals for the Third Circuit at Nos. 11,066 and 11,067, affirming the Decisions (R. 65a, 66a) of the Tax Court of the United States entered January 12, 1953. The cases were consolidated for hearing before the Tax Court (R. 2a; 6a) and for hearing, consideration and opinion before the Court of Appeals (R. 129-130).

OPINIONS BELOW.

The Findings of Fact and Opinion of the Tax Court (R. 8a-29a) are officially reported at 18 T.C. 1032. The Opinion of the Court of Appeals (R. 136-151) has not been reported.

JURISDICTION.

The Judgments of the Court of Appeals were entered on December 31, 1953 (R. 151a 152). A Petition for Rehearing was filed February 1, 1954 (R. 155-186). On February 15, 1954, the Court of Appeals denied the Petition for Rehearing (R. 187-188). The jurisdiction of this Court is invoked under the Act of June 25, 1948, c. 646, 62 Stat. 869, 928 (28 U.S.C., Sec. 1254).

QUESTIONS PRESENTED.

1. Where (a) during the years 1936 to 1941, inclusive, Gustave H. Kann (hereafter called G. H. Kann, now deceased and here represented by his Executors) and petitioner W. L. Kann were brothers, stockholders owing directly in excess of 20% of the outstanding capital stock of Pittsburgh Crushed Steel Company (hereafter called PCS), a Pennsylvania corporation, at least 90% of whose stock was owned by 25 members of "the Kann family" (R. 136, 142) and were respectively, President-General Manager and Secretary, Treasurer and Assistant General Manager of PCS, with W. L. Kann personally making the entries in and keeping the books and records thereof (R. 19a; 137); and (b) during said

years G. H. Kann and W. L. Kann devised and carried out an intricate system of embezzling money from PCS (R. 71a, 74a, 75a, 86a-88a, 99a, 108a, 110a, 112a, 122a-123a), which included the deliberate overstatement of purchases (R. 31a, 68a, 69a, 71a, 106a), the understatement of sales (R. 71a, 72a, 86a, 87a, 106a, 121a, 31a), numerous fictitious accounts (R. 31a, 72a, 106a, 111a), hundreds of falsified entries in the company's books (R. 31a, 71a, 75a), and from 200 to 300 checks illegally drawn to the order of G. H. Kann and W. L. Kann (R. 31a, 71a, 107a, 122a) and thereby took unto themselves $675,881.76 of money belonging to PCS, with W. L. Kann deliberately and intentionally making false and fictitious entries designed to conceal such "misappropriations" (R. 143) or deliberately failing to record them in the books and records of PCS, all with the knowledge, consent and participation of G. H. Kann (R. 19a, 61a, 71a, 91a, 93a, 96a, 99a, 112a, 118a), with both of them admitting herein that they had no claim of right to such money, no authority to take it and that they had stolen the money from the company, in which many of their own close relatives were stockholders (R. 68a, 69a, 74a, 88a, 93a, 96a, 112a, 117a, 118a); and (c) after the amounts of money stolen had been determined by an examination of PCS's books by a certified public accountant the total thereof was entered in the books of PCS as a debt owing by G. H. Kann and W. L. Kann to PCS and remained so at all times (R. 76a, 96a, 100a, 101a; 52a, 77a, 79a, 80a, 88a, 97a, 102a, 111a), with partial payments thereon totaling over $250,000.00 being made by G. H. Kann and W. L. Kann to PCS and with their executing a promissory note to it for the amount determined by the certified public accountant to be owing and endors-

ing over and pledging to PCS all of their stock in PCS as collateral security for their note, with the company's records showing that no part of said debt had been forgiven or condoned (R. 21a-25a, 52a-55a, Ex. 19-3, R. 52); and (d) with none of the money so stolen ever having been declared payable to G. H. Kann and W. L. Kann as dividends (R. 51a, 57a): Did the Tax Court commit reversible error in finding as a fact that (R. 26a, 27a) "During 1936 to 1941, inclusive, petitioner W. L. Kann and his brother, Gustave H. Kann, through stock ownership, family relations, and their positions as directors and officers, of Secretary, Treasurer and President, respectively, acting jointly and in association with each other, exercised control of PCS" and "caused the amounts received by them from PCS * * * to be paid by virtue of their control over PCS * * *" as "Dividend income understated" (R. 8a, 9a), and in failing to find as a fact that G. H. Kann and W. L. Kann had, without any bona fide claim of right, fraudulently taken and converted to their own use money belonging to PCS?

2. Where (a) from 1936 through 1941 G. H. Kann and W. L. Kann, were, respectively, President and Vice President of Globe Steel Abrasive Company (hereafter called GSA), an Ohio corporation, wholly-owned by PCS; and (b) during said years they devised and carried out an intricate system of embezzling money from GSA, under which, pursuant to instructions from W. L. Kann to the bookkeeper of GSA and with the knowledge, assistance and cooperation of the Secretary and General Manager of GSA, G. H. Kann and W. L. Kann received the sum of $66,000.00 in the form of checks from GSA, none of which were recorded on the books and records

of GSA and all of which were concealed by understating sales in such books and records, with G. H. Kann and W. L. Kann admitting herein that they had no claim of right to such money or authority to take it and that they had stolen the money from GSA (R. 20a, 21a, 85a-94a, 112a-113a, 117a-118a, 119a-125a); and (c) after the amounts of money stolen by them had been determined by an examination of the books of GSA by a certified public accountant, they were placed upon the books of GSA as a debt owing by G. H. Kann and W. L. Kann to GSA and remained so at all times (R. 57a-61a), with partial payments made thereon by G. H. and W. L. Kann totaling $44,550.35 and with the balance owing by said Kanns of $30,449.65 (R. 60a-61a), with GSA's records showing that no part of said debt had been forgiven or condoned and that none of the money stolen had ever been declared payable to G. H. and W. L. Kann as dividends (R. 19a, 32a, 57a, 58a): Did the Tax Court commit reversible error in finding as a fact (R. 27a) that G. H. Kann and W. L. Kann "exercised control of GSA, the wholly-owned subsidiary of PCS" and "caused the amounts received by them from * * * GSA, * * * to be paid by virtue of their control over * * * GSA, as "Dividend income understated" (R. 8a-9a), and in failing to find as a fact that G. H. Kann and W. L. Kann had, without any bona fide claim of right, fraudulently taken and converted to their own use money belonging to GSA?

3. Whether under the facts herein, as briefly set forth above under Questions Presented 1 and 2, the Tax Court committed reversible error in finding and concluding as a matter of law that such amounts were includible

in gross income under Section 22(a) of the Revenue Acts and/or Internal Revenue Code applicable to the years 1936 to 1941, inclusive, and in failing to find and conclude as a matter of law that the conduct of G. H. Kann and W. L. Kann constituted embezzlement and that under the decision of this Court in *Commissioner of Internal Revenue v. Wilcox,* 327 U.S. 404,, the moneys which G. H. Kann and W. L. Kann had embezzled were not includible in gross income?

4. Where income tax returns signed only by petitioner W. L. Kann for the years 1937 and 1938 contained in the space provided for the name and address of the taxpayer the names "W. L. Kann and Stella H. Kann," the explanatory language printed on the returns under these names reading as follows: "(Name) (Both Husband and Wife, if a joint return)," and where the answer "Yes" was given to the question on said returns which read: "Are items of income or deductions of both husband and wife included in this return?", Did the Tax Court commit reversible error in finding as a fact (R. 26a) that, "Petitioners W. L. Kann and Stella H. Kann filed joint returns for the years 1937 and 1938" and in failing to find that petitioner Stella H. Kann did not file joint income tax returns with her husband, W. L. Kann, for said years?

5. Where, even if the Tax Court did not commit reversible error in finding as a fact that petitioners W. L. Kann and Stella H. Kann filed joint returns for the years 1937 and 1938, absent a showing of fraud as to petitioner Stella H. Kann, Did the Tax Court commit reversible error in finding and concluding as a matter of law that petitioner Stella H. Kann is liable for fraud penalties for the years 1937 and 1938 and in failing to find and conclude

that there is no liability on her part for fraud penalties for said years, because the Commissioner of Internal Revenue failed to discharge his affirmative burden of proof with respect to any fraudulent intent on her part to evade income taxes?

6. Whether the Court of Appeals committed reversible error in affirming the Tax Court?

STATUTES AND REGULATIONS INVOLVED.

The pertinent portions of the statutes and regulations involved are set out in the Appendix, *infra*, pages 50-55.

STATEMENT.

In his Notices of Deficiencies addressed to petitioners W. L. Kann and Stella H. Kann, husband and wife, and Gustave H. Kann (now deceased) the Commissioner determined deficiencies in income tax against W. L. Kann and Stella H. Kann, husband and wife, for the years 1936 to 1941, inclusive, in amounts totaling $233,198.88 and asserted 50% fraud penalties thereon under Section 293 of the Internal Revenue Code totaling $117,048.69, and deficiencies in income tax against Gustave H. Kann for said years in amounts totaling $246,162.46 and asserted 50% fraud penalties thereon of $123,547.93 under Section 293 of the Internal Revenue Code.

Said deficiencies in tax resulted principally from the Commissioner's adding to the net income reported by each of said Gustave H. Kann and W. L. Kann for said

years that portion of the item described under each of said years in the Commissioner's Notices of Deficiencies as "Dividend income understated" which related to amounts claimed by Gustave H. Kann and W. L. Kann to have been embezzled by them from PCS in the total of $675,881.76 and from GSA in the total of $66,000.00.

In the petitions filed in these cases in the Tax Court error was alleged in the Commissioner's addition to income of said items described in the Notices of Deficiencies as "Dividend income understated", and petitioner Stella H. Kann also alleged that the Commissioner erred in including her name as one of the individuals to whom his Notice of Deficiency was addressed, insofar as the years 1936 to 1940, inclusive, were concerned, and in determining a joint tax liability with her husband, W. L. Kann, and fraud penalties against her for said years. At the trial the Commissioner conceded (R. 8a) "that for the year 1936, 1939 and 1940, petitioner Stella H. Kann did not file joint individual income tax returns with her husband, petitioner W. L. Kann."

As to the amounts embezzled by G. H. and W. L. Kann from funds belonging to PCS:

During the years 1936 to 1941, inclusive, PCS was a corporation organized under and existing by virtue of the laws of the Commonwealth of Pennsylvania, with its principal place of business at Pittsburgh therein. At all times during 1936 and until December 18 of that year, the outstanding capital stock of PCS was 1,000 shares with par value of $100.00 per share. Kann-Pangborn Co. held 997 shares; Bertha F. Kann, G. H. Kann and W. L. Kann held one share each. On December 18, 1936, the

outstanding capital stock of PCS was increased to 5,000 shares with a par value of $100.00 a share held as follows: Kann-Pangborn Co., 4,997 shares; Bertha F. Kann, G. H. Kann and W. L. Kann, one share each (R. 9a).

During the years 1936 to 1941, inclusive, the officers of PCS were G. H. Kann, President; Bertha F. Kann, Vice-President; and W. L. Kann, Secretary and Treasurer. These officers constituted the entire Board of Directors until February, 1940, when A. Leo Weil, Jr., and Thomas W. Pangborn were elected to the Board. G. H. Kann voted the stock of Bertha F. Kann in the years 1936 to 1940, inclusive. W. L. Kann and G. H. Kann voted her stock in 1941. During the years 1936 through 1941, management of the operations of PCS was confined solely to G. H K.ann and W. L. Kann (R. 16a).

Of the 5,000 shares of stock of PCS outstanding between 1936 and 1941, G. H. Kann never owned more than 969, approximately 19%, and W. L. Kann never owned more than 283, approximately 6%. (R. 10a, 36a).

During 1936 through 1941, G. H. Kann and W. L. Kann devised and carried out an intricate system of embezzling money from PCS (R. 71a, 74a, 75a, 86a-88a, 99a, 108a, 110a, 112a, 122a-123a), which included the deliberate overstatement of purchases (R. 31a, 68a, 69a, 71a, 106a), the understatement of sales (R. 71a, 72a, 86a, 87a, 106a, 121a, 31a), hundreds of falsified entries in the company's books (R. 31a, 71a, 75a), and from two to three hundred checks illegally drawn to the order of G. H. Kann and W. L. Kann (R. 31a, 71a, 107a, 122a). G. H. Kann and W. L. Kann deliberately falsified the books and other records of PCS as a part of their scheme to embezzle

funds from it and to conceal their embezzlements from stockholders (R. 61a, 71a, 91a, 93a, 96a, 99a, 112a, 118a). They did not claim any right to the money and admitted herein they had no authority to take it and that they embezzled the funds from the company in which many of their own close relatives were stockholders (R. 68a, 69a, 74a, 88a, 93a, 96a, 112a, 117a, 118a).

During the years 1936 to 1941, inclusive, W. L. Kann personally made the entries in and kept the books and records of PCS. With respect to the "payments" out of funds of PCS to W. L. Kann and G. H. Kann involved herein, W. L. Kann personally made "such payments" and deliberately and intentionally made false and fictitious entries designed to conceal the "payments" or deliberately failed to record them in the books and records of PCS, all with the knowledge, consent and participation of Gustave H. Kann (R. 19a).

W. L. Kann and G. H. Kann not only concealed their embezzlements, but did so in such a manner that it required the services of a certified public accountant to determine the sums embezzled (R. 76a, 96a, 100a, 101a). An audit made sometime in late 1942 or early 1943 by a certified public accountant of the books and records of PCS for the years 1936 to 1941, inclusive, showed a total of $660,018.68 had been taken by Gustave H. Kann and W. L. Kann out of funds of PCS during the years 1936 to 1941, inclusive, this total of $660,018.68 being included in the total of $675,881.76 included in gross income by the Commissioner as having been "received" by said Kanns out of funds of PCS during those years as "Dividend income understated" (R. 21a, 8a-9a). Two Internal

Revenue Agents spent 15 months going over the books of PCS in order to determine the amounts of the embezzled funds and the methods used in embezzling them (R. 125a, 126a, 127a).

After the certified public accountant had determined the amounts taken from the funds of PCS by the Kanns during the years 1936 through 1941, the total amount of $660,018.68 was immediately entered in the books of PCS as a debt owing by said Kanns to it and remained so at all times (R. 52a, 77a, 79a, 80a, 88a, 97a, 102a, 111a). Thereafter said Kanns made partial payments to PCS to reduce and partially liquidate their debt, and no part of the debt has ever been forgiven or condoned (R. 22a, 52a, 53a, 54a, 79a, 80a, 97a, 111a). From December 14, 1943, through December 11, 1946, PCS was paid by W. L. Kann and G. H. Kann on account of their indebtedness to it amounts aggregating $251,779.07 (R. 21a-22a).

When the other directors and stockholders of PCS learned of the taking of PCS's funds by G. H. and W. L. Kann, said Kanns executed a promissory note to PCS for $660,018.68 and endorsed over to and pledged with PCS all of their stock in PCS as collateral security for their note (R. 55a, 78a, 79a, 80a, 83a, 97a, 114a, 104a, 115a, 119a).

All dividends declared by the Board of Directors of PCS and in due course paid to G. H. Kann and W. L. Kann as stockholders thereof during the years 1936 through 1941 were included in the gross incomes of G. H. Kann

and W. L. Kann in the income tax returns filed by them for said years (R. 9a, 51a-52a).

As to the amounts embezzled by G. H. and W. L. Kann from funds belonging to GSA:

During the years 1936 to 1941, inclusive, GSA was a corporation organized under and existing by virtue of the laws of the State of Ohio, with its principal place of business at Mansfield therein. During such years it was a wholly-owned subsidiary of PCS (R. 19a).

During the years 1936 to 1941, inclusive, the officers of GSA were G. H. Kann, President; W. L. Kann, Vice-President; and Paul McConnell, Secretary and General Manager. During that period Dick S. Porch kept the books and records of GSA (R. 19a).

In the years 1936 to 1941, inclusive, W. L. Kann and G. H. Kann each received out of funds of GSA $3,000.00 in the year 1936 and $6,000.00 in each of the years 1937 through 1941, a total of $66,000.00, no part of which was included in gross income in their respective income tax returns for those years (R. 20a). These amounts were received in the form of GSA checks, none of which were recorded on the books and records of that company, but they are identified with understated sales on such books and records (R. 20a). Dick S. Porch, the bookkeeper at GSA, pursuant to instructions from W. L. Kann, prepared the checks covering said $66,000.00, deliberately and intentionally failed to record them in the books and records of GSA, and deliberately off-set them by understating sales in such books and records, all with the knowledge, consent and co-operation of G. H. Kann and

of Paul McConnell, the Secretary and General Manager of GSA (R. 21a).

Following an examination of the books and records of GSA by a certified public accountant entries were made upon the books and records of GSA showing that G. H. Kann and W. L. Kann were indebted to GSA on account of the receipt by them of said funds of GSA and thereafter G. H. Kann and W. L. Kann made payments to GSA on account of said indebtedness in amounts aggregating $42,000.00 (R. 85a-90a, 119a-125a; pars. 46-51, Supp. Stip., R. 60a, 61a).

Both G. H. Kann and W. L. Kann admitted herein they had no claim of right to said money received from GSA, no authority to take and/or receive them and that they had stolen the money from GSA (R. 68a, 69a, 74a, 88a, 93a, 96a, 112a, 117a, 118a).

The books and records of GSA contain entries showing that no part of said debt has been forgiven or condoned, the balance shown therein as owing by G. H. and W. L. Kann to GSA at December 30, 1949, on account of said embezzlements being $30,449.65 (Par. 51a, Supp. Stip. R. 61a).

All of the dividends declared by the Board of Directors of GSA during the years 1936 to 1941, inclusive, were paid to and received by PCS, the sole stockholder of GSA (Pa. 37a, Supp. Stip., Ex. 27-AA, R. 57a; par. 38, Supp. Stip., R. 58a).

As to the liability of petitioner Stella H. Kann for deficiencies and fraud penalties for the years 1937 and 1938:

The income tax returns signed only by petitioner W. L. Kann for the years 1937 and 1938 contained in the space provided for the name and address of the taxpayer the names "W. L. Kann and Stella H. Kann". The explanatory language printed on the returns under their names reads as follows: "(Name) (Both husband and wife, if a joint return)". The answer "Yes" was given to the question on the return signed by petitioner W. L. Kann for 1937 and 1938 which read: "Are items of income or deductions of both husband and wife included in this return?" (R. 26a).

SPECIFICATIONS OF ERRORS TO BE URGED.

In affirming the decisions of the Tax Court petitioners aver the Court of Appeals committed errors of law as follows:

1. In failing to conclude that the Tax Court committed reversible error in finding as a fact that (R. 26a, 27a) "During 1936 to 1941, inclusive, petitioners W. L. Kann and his brother, Gustave H. Kann, through stock ownership, family relations, and their positions as directors and officers, of Secretary, Treasurer and President, respectively, acting jointly and in association with each other, exercised control of PCS" and "During 1936 to 1941, inclusive, by similar means petitioners W. L. Kann and Gustave H. Kann exercised control over GSA, the wholly-owned subsidiary of PCS" and "caused the amounts received by them from PCS and GSA, * * *

to be paid by virtue of their control over PCS and GSA," as "Dividend income understated" (R. 8a, 9a), and in the Tax Court's failing to find as a fact that G. H. Kann and W. L. Kann had, without any bona fide claim of right, fraudulently taken and converted to their own use money belonging to PCS and GSA.

2. In failing to conclude that the Tax Court had committed reversible error when it failed to find as a matter of law that the Kanns' conduct constituted embezzlement.

3. In concluding that the money involved in "the misappropriations of PCS and GSA funds" (R. 143) constitutes taxable income to W. L. Kann and G. H. Kann, because such conclusion is in conflict with the decision of this Court in *Commissioner v. Wilcox,* 327 U.S. 404, wherein this Court held that embezzled funds do not constitute taxable income to the embezzler.

4. In concluding that the decision of this Court in *Rutkin v. United States,* 343 U.S. 130, overruled the decision of this Court in *Commissioner v. Wilcox, supra,* and that since this Court's decision in *Rutkin* embezzled money constitutes taxable income to the embezzler, because this Court did not state in *Rutkin* that it was overruling its decision in *Wilcox* and did not as a matter of *fact* or *law* do so, and until this Court does so state and do, the Court of Appeals is "required to follow Wilcox in embezzlement cases." (R. 145).

5. In concluding that as to the money involved in "the misappropriations of PCS and GSA funds" the Tax Court (R. 140) "correctly held the instant case to be con-

trolled by *Rutkin,* not *Wilcox,* particularly in view of the gloss put on the *Wilcox* case by the *Rutkin* decision", because "the Rutkin principle" (R. 27a) sanctioned the inclusion in gross income of the money there obtained through "extortion", which funds as income this Court in its opinion in *Rutkin* and the gloss therein clearly distinguished from the non-taxable "embezzled funds" of its *Wilcox* decision.

6. In concluding that Stella H. Kann filed joint income tax returns with her husband, W. L. Kann, for the years 1937 and 1938, because it is in conflict with the decision of the Court of Appeals for the Third Circuit in *McCord v. Granger,* 201 F. (2d) 103 (1952).

7. In concluding that Stella H. Kann absent a showing of fraud as to her is liable for 1937 and 1938 fraud penalties, because such conclusion completely ignores the provisions of Section 1112 of the Internal Revenue Code placing the burden of proof on the Commissioner of Internal Revenue to establish the presence of "fraud with intent to evade tax" and is in conflict with the decision of the Court of Appeals of the Third Circuit in *Maddas v. Commissioner,* 114 F. (2d) 548, (1940) and the decisions of other Courts of Appeals.

8. In affirming the Tax Court.

REASONS FOR GRANTING THE WRIT.

As to Errors 1 and 2: The Court of Appeals committed errors of law (1) in failing to conclude that the Tax Court committed reversible error (a) in finding as a fact that G. H. and W. L. Kann exercised control over PCS and GSA and caused the amounts received by them from said companies to be paid by virtue of such control, as "dividend income" and (b) in failing to find as a fact that said Kanns had, without any bona fide claim of right, fraudulently taken and converted to their own use money belonging to PCS and GSA, and (2) in failing to conclude that the Tax Court had committed reversible error when it failed to find as a matter of law that the Kanns' conduct constituted embezzlement.

The determination of the Tax Court on the issue involving the taxability of the money the Court of Appeals terms the "misappropriations of PCS and GSA funds" (R. 143) and its Decisions based thereupon are grounded upon an obvious distortion and ignoring of the facts and a manifest disregard of the law applicable to the uncontroverted facts. The Tax Court's determination of this issue and the failure of the Court of Appeals to reverse that determination ignore the realities of the case and are clearly erroneous. The Court of Appeals (in the application to the instant case of what is considers "the Rutkin principle"), while *clearly rejecting* the finding and conclusion of the Tax Court (R. 27a) that "W. L. Kann and Gustave H. Kann caused the amounts received by them from PCS and GSA, and herein contested, to be paid by virtue of their control over PCS and GSA" (and thus under a claim of right, as contended in the Tax Court and in the Court of Appeals by the Commissioner) and

definitely concluding (R. 144) that the moneys here involved were "misappropriations of PCS and GSA funds", to which W. L. Kann and G. H. Kann (R. 139) "had no more claim of right * * * than did Rutkin to the fruits of his extortion", nevertheless, in an endeavor to justify the application of "the Rutkin principle" by seeking to distinguish "the present appeal * * * from the facts in Wilcox" (R. 140) ignored *stipulated* and other *uncontroverted facts* and *the law applicable thereto* and thus committed the same errors of law as did the Tax Court.

The Dissenting Opinion of the Court of Appeals herein characterizes the action of the Tax Court in determining these cases as (R. 148) "an amazing dexterity in judicial legerdemain", because (R. 148):

> "* * * It ignored the plain and unmistakable meaning of the word embezzlement and the essential elements of the crime of embezzlement. It ignored a stipulated record which demonstrated beyond any possible doubt that the two Kanns, in a most shameful abuse of the confidence reposed in them as executives and directors of their corporate employers, by means of crooked manipulation and financial juggling looted their employers of approximately $750,000. * * *.
>
> "The Tax Court further ignored the stipulated facts that following discovery of the embezzlement late in 1942 by the PCS auditor, the latter, with the concurrence of the Kanns noted upon the books of PCS their indebtedness to PCS in the amount of the embezzled funds, and that the Kanns later made restitution to PCS of $251,000 and to GSA of $45,000, and, in addition executed a note to PCS covering

their emmbezzlement and assigned all their stock in PCS as collateral for their obligation.

"Not only did the Tax Court ignore the stipulated facts establishing the embezzlements, but it also ignored the uncontradicted sworn testimony of both the Kanns at the hearing that they had 'stolen' the embezzled funds and had done so 'without any claim of right.'

"It did so despite the fact that Mr. Dickinson, government counsel, had stated at the Tax Court hearing that he was not challenging the credibility of the Kanns or any of the witnesses testifying as to their embezzlement.

* * * * * * *

"The government's contention that despite the fact that the Kanns 'surreptitiously procured for their own use funds from family owned corporations' the funds so taken were not embezzled is, to say the least, ingenious. 'Surreptitiously procured' is undoubtedly more euphonious and less grating on the embezzler's ear; but embezzlement, called by any other name, is still embezzlement."

Based upon all of the uncontroverted facts in the record herein and particularly those hereinbefore set forth, unless this Petition for a Writ of Certiorari is granted and the errors of law in the decision of the Court of Appeals and the Judgments entered thereupon are reversed, a grave injustice will be done to petitioners.

As to Error 3: The conclusion of the Court of Appeals that the money involved in (R. 143) "the misappropriations of PCS and GSA funds" constitutes taxable income is clearly erroneous, because it is in conflict with the decision of this Court in Commissioner v. Wilcox, supra, wherein this Court held that embezzled funds do not constitute taxable income to the embezzler.

The Tax Court finally concluded (R. 27a) that W. L. Kann and Gustave H. Kann caused the moneys here involved "to be paid" to them "by virtue of their control over PCS and GSA", and in its Opinion, by "confining the *Wilcox* 'case to its facts,' " concluded that "there are adequate distinctions to require the present application of the *Rutkin* principle." Nowhere in the Tax Court's Opinion did it make the slightest effort to state what "the *Rutkin* principle" was or why it was applicable here. It made no finding of fact, as under the stipulated and uncontroverted facts it should have (as the Dissenting Opinion of the Court of Appeals states and thereby committed reversible error), "that the Kanns had, without any bona fide claim of right, fraudulently taken and converted to their own use money belonging to PCS and GSA" (R. 150), *nor did the Tax Court find as a fact that the money involved had been "extorted" by the Kanns from PCS and GSA,* that Court merely stating, "The difficulty of drawing any satisfactory distinction between the 'embezzlement' in *Commissioner v. Wilcox,* * * * and the 'fraud' and 'unlawful gains' in *Rutkin v. United States,* * * * is exemplified here," and then set forth, through what the Dissenting Opinion of the Court of Appeals characterizes as (R. 148) "an amazing dexterity in judicial legerdemain", what it considered the

"adequate distinctions to require the present application of the *Rutkin* principle" (R. 27a).

Not only did the Tax Court, as plainly shown by the quotation from the Dissenting Opinion of the Court of Appeals above, commit reversible error when it failed to find as a fact (upon a record which demonstrated that beyond any possible doubt), that the Kanns had, without any bona fide claim of right, fraudulently taken and converted to their own use money belonging to PCS and GSA, but both that Court and the Court of Appeals committed reversible error when each failed to conclude as a matter of law that the Kanns' conduct constituted embezzlement and that under the decision of this Court in the *Wilcox* case the moneys which they had embezzled were not taxable income.

Treating of the "adequate distinctions" which the Tax Court and the Court of Appeals determined justified the non-application of the "embezzlement funds" rule of the *Wilcox* case to what the Court of Appeals terms "the misappropriations of PCS and GSA funds" (R. 143) here involved (and which distinctions the Dissenting Opinion of the Court of Appeals terms [R. 146] "distinctions without a difference"), the Tax Court states (R. 27a) that "Petitioners were never indicted or convicted of embezzlement, and there is hence no external evidence as there was in *Wilcox* that they were guilty of that offense." In its Opinion the Court of Appeals repeats what the Tax Court there said and then adds (R. 140) "nor does it appear that those concerned with the corporate affairs of PCS or GSA, or anyone else, ever urged prosecution." This Court did *not* say, as both the Tax Court and the Court of Appeals erroneously con-

cluded, that there *had* to be "external evidence" such as an indictment or conviction, or *even* the *urging* of prosecution, as the Court of Appeals would add as above, before there could be an "embezzlement" within the ambit of the *Wilcox* case, but, rather, this Court said *exactly* the *opposite,* namely:

> "* * * Under Nevada law the crime of embezzlement *was complete* whenever an appropriation was made, the employer was entitled to recover the money as soon as it was appropriated or to have it summarily restored by a magistrate." (Emphasis supplied.)

And, clearly, we submit, under Pennsylvania law (18 Purdon, Section 4827) the crime of embezzlement was complete whenever an appropriation was made, because that law provides quite plainly as follows:

> "Embezzlement by officers of corporations. Whoever, being an officer, director, * * * manager, * * * employee, * * * of any * * * body corporate, * * * fraudulently takes, converts or applies to his own use, or to the use of any other person, any of the money or other property of such * * * body corporate or company, * * * or belonging to any person or persons, corporation or association and deposited therein, or in possession thereof, is guilty of embezzlement, * * *."

Under Pennsylvania law (Act of March 17, 1869, P. L. 8, 12 Purdon §§ 2711-2716) the obligation of the Kanns to return the money stolen by them from the funds of PCS was a debt for which attachment lies. *O'Neill v. Brown,* 17 Dist. 1062, 21 York 200, 24 Montg. 77; *Maitland Driving Park v. Fisk,* 3 Lack. L.N. 210, 11 York 69.

Under Ohio law (Throckmorton's Ohio Code Ann., Vol. IV, Section 12467) the embezzlement of the GSA funds was complete whenever an appropriation was made, that law providing:

> "Whoever, being an officer, * * * embezzles or converts to his own use, fraudulently takes or makes away with, or secretes with intent to embezzle or convert to his own use anything of value which shall come into his possession by reason of his election, appointment or employment thereto, if the total value of the property embezzled * * * is $35.00 or more, shall be imprisoned * * *."

But the Court of Appeals, despite these plain provisions of the Pennsylvania and Ohio laws and despite a record herein which demonstrated beyond any possible doubt that the Kanns' conduct constituted embezzlement, nevertheless concluded (R. 142-143) that "Such local law concept of embezzlement" should not, in its opinion, "be used as a vehicle for tax avoidance, absent a clear mandate to the contrary." The "clear mandate to the contrary" that embezzled funds are *not* taxable income to the embezzler is the decision of this Court in the *Wilcox* case, in which it plainly held that the crime of embezzlement was complete *under the local law* whenever an appropriation was made, and that since (p. 408):

> "* * * a *taxable gain* is conditioned upon (1) the presence of a claim of right to the alleged gain and (2) the absence of a definite, unconditional obligation to repay or return that which would otherwise constitute a gain", (Emphasis supplied.)

and "All right, title and interest in the money rested with the employer", who "at all times held the taxpayer liable

to return the full amount", "The taxpayer thus received no taxable income from the embezzlement", and, accordingly, without there being *taxable income,* the "local law concept of embezzlement" could *not* be used as a vehicle "for tax avoidance".

The next "adequate distinction" which the Tax Court concluded justified the non-application of the "embezzlement funds" rule of the *Wilcox* case to the instant case (R. 27a) is that W. L. and G. H. Kann "were in complete control of the corporations from which they obtained the funds." The Tax Court said nothing further about this "adequate distinction", but the Court of Appeals treats of this as (R. 142) "The important distinctions between the Wilcox case and this appeal, however, concern the relationship of the taxpayers to their employers"; that "whereas Wilcox was merely a salaried employee, the Kanns controlled PCS and GSA"; that "the Kann family owned * * * at least 90% of the stock in PCS", while "G. H. and W. L. Kann directly owned in excess of 20% of PCS stock", with the "management of the operations of PCS * * * confined solely to G. H. and W. L. Kann", GSA being "a wholly owned subsidiary of PCS" from all of which the Court of Appeals concluded that (R. 142) "It is thus readily apparent that but for the alleged embezzlement 90% of the money in question (less corporate taxes) would in the normal course of events have been returned to the family in the form of dividends or capital", and that "Unlike the situation in Wilcox, where the taxpayer would not have received the proceeds except for his conversion, the Kanns were to a large extent taking their own money." Not only is this latter statement, as declared by the Dissenting Opinion of the Court

of Appeals (R. 147), "entirely without basis", but it is *directly contrary to the statement and conclusion of the Court of Appeals* (R. 139) that G. H. Kann and W. L. Kann "had no more claim of right * * * to the money involved in the present issue" than "did Rutkin to the fruits of his extortion"!

The next "adequate distinction" which the Tax Court concluded justified the non-application of the law of the *Wilcox* case to the instant case (R. 27a) was that, "there is in fact no adequate proof that the method, if not the act, has not been forgiven or condoned." The Appellate Court's treatment of that "distinction" (R. 141) is merely to repeat it. As is clearly shown by the Dissenting Opinion herein (R. 148), the Tax Court in concluding there was no *adequate* proof of forgiveness or condonation (and the Court of Appeals in reiterating that conclusion):

> "* * * ignored the stipulated facts that following discovery of the embezzlement late in 1942 by the PCS auditor, the latter, with the concurrence of the Kanns noted upon the books of PCS their indebtedness to PCS in the amount of the embezzled funds, and that the Kanns later made restitution to PCS of $251,000 and to GSA of $45,000, and, in addition executed a note to PCS covering their embezzlement and assigned all their stock in PCS as collateral for their obligation."

In addition to ignoring such uncontroverted facts directly contrary to the conclusion drawn by the Tax Court, both that Court and the Court of Appeals also ignored the books and records of each of the companies there involved showing the remainder of the embezzled

funds unpaid at the time of the trial of these cases and as well both the Minutes of Meetings of the Stockholders and Directors of said companies right up to the time of trial of this case showing that there was, beyond any reasonable doubt, no forgiveness of the indebtedness recognized by G. H. and W. L. Kann and said companies as arising from said embezzlements or any condonation of the Kanns' acts in connection therewith, and that each of said companies from and after the determination of the amounts of such embezzlements at all times held the Kanns liable to return the full amounts, with the debtor-creditor relationship being unconditional (Supp. Stip., Pars. 21, 26-29, 37, 46-51, R. 51a-61a).

The Tax Court failed to take into consideration, as did also the Court of Appeals in its Opinion here, that all this Court said in the *Wilcox* case with respect to the condonation or forgiveness of any part of the money embezzled there was:

> "* * * or had his [the embezzler's] employer condoned or forgiven any part of the unlawful appropriation the taxpayer *might* have been subject to tax liability to that extent. But neither situation is present in this proceeding and *we need not explore* such possibilities" (Emphasis supplied);

after which this Court stated:

> "* * * Sanctioning a tax under the circumstances before us would serve only to give the United States an unjustified preference as to part of the money which rightfully and completely belongs to the taxpayer's employer."

And petitioners submit that the unlawful determination of the Court of Appeals sanctioning the tax determined by the Commissioner in this case likewise serves only to give the United States an unjustified preference to money which rightfully and completely belongs to Pittsburgh Crushed Steel Company and Globe Steel Abrasive Company.

Under the facts of this case there could not possibly have been any condonation or forgiveness of the acts and debts of the Kanns in any of the years 1936 through 1941, because the record clearly shows (Supp. Stip., Par. 26, R. 52a) that it was not until the end of 1942 or in 1943 before the certified public accountant determined the amounts of the embezzlements; not until the meeting held September 15, 1947, (Supp. Stip., Par. 21, R. 50a; R. 22a-23a) before the Board of Directors of PCS had the matter of the embezzlements brought to its attention; and not until the meeting of August 5, 1948, before the embezzlements from the funds of PCS were considered at a meeting of stockholders (Supp. Stip., Par. 21, R. 50a). The minutes of that meeting clearly show that there was no condonation of the acts of the Kanns nor forgiveness of their indebtedness to the company. The minutes clearly show that one of the brothers of the Kanns and two other stockholders having no relation to them were of opinion that the prospects of the company at that time or in the near future of collecting the indebtedness of the Kanns and the note given in connection therewith "were practically negligible and that it was * * * the duty of the company to take over the collateral and apply it either as part payment or full payment of the said indebtedness and note."

And even if there were any forgiveness of indebtedness which would bring about "taxable income", that part of the debt forgiven which became "taxable income" could only be such in the debtor's taxable year in which the debt was forgiven. *Commissioner v. Jacobson,* 336 U.S. 28.

Thus it is plain, as pointed out by the dissenting opinion of this Court (R. 148) that whether the embezzlers' victims condoned their misconduct or forgave them was "utterly irrelevant to the issue as to whether the Kanns embezzled the money," to bring the case within the rule of *Wilcox.*

The next "adequate distinction" which the Tax Court used in an attempt to justify its failure to conclude that the Kanns had embezzled the funds at issue and thus require the application of the *Wilcox* rule and the conclusion that the "misappropriations" were not taxable income (and which "distinction" is likewise mentioned by the Court of Appeals in its determination —R. 141) is that, "The details of the supposed liability to repay are such as to leave serious doubt whether the whole project was not a false front erected to deceive not the corporation nor its stockholders but the Commissioner of Internal Revenue." (R. 27a). The record here incontrovertibly shows (Supp. Stip., Pars. 21, 26-29, 32, 46-51, R. 51a-61a), as the Dissenting Opinion of the Court of Appeals plainly states (R. 148), but which facts both the Tax Court and the Court of Appeals completely ignored, that there was not any "supposed" liability but a very actual one, without any strings or contingencies attached thereto, and upon which up to the date of the

trial of this case the Kanns had paid amounts aggregating approximately $296,000.00.

In an endeavor to support the absolutely unfounded conclusion of the Tax Court immediately above quoted, the Court of Appeals states (R. 141):

> "* * * to the extent that the above views involved questions of fact and an opportunity to observe G. H. and W. L. Kann, as well as other witnesses, on the stand, they should not lightly be disturbed."

Even if that were true, which the record shows is not the case, the facts incontrovertibly showing there was an actual and not a "supposed" liability to repay are not based upon testimony of "G. H. and W. L. Kann, as well as other witnesses" but upon "stipulated" facts (R. 52a-61a), which the Commissioner of Internal Revenue agreed (R. 48a) "may be accepted as facts but without prejudice to the contentions of either party as to the relevancy or materiality thereof and * * * without prejudice to the right of either party to introduce other and further evidence at the trial of these cases not inconsistent with the facts herein stipulated; * * *." The record herein can be most carefully examined from beginning to end and there will not be found therein any objection of the Commissioner based on "relevancy or materiality", or anything else, that the *liabilities* in question were anything other than "actual" ones.

The Tax Court next, in a continuation of its determination not to conclude that the Kanns' conduct constituted embezzlement and that the "misappropriated" funds were not taxable income under the law of *Wilcox,*

stated (R. 28a), "* * * certainly no testimony from these petitioners, * * * can be availed of to carry any of the burden that their version of the facts is reliable." The Dissenting Opinion of the Court of Appeals plainly shows (R. 149-150) that the Commissioner's counsel stipulated at the Tax Court hearing that he was not challenging the credibility of the Kanns or any of the witnesses testifying as to their embezzlements, and both of the Kanns testified that they had "stolen" the embezzled funds and had done so without any claim of right (R. 149, 92a-94a, 105a-116a, 117a-118a). But despite what the record thus clearly shows, the Court of Appeals, nevertheless, concluded that the Tax Court "properly" pointed out that the testimony of the Kanns was not entitled to any credence!

The final effort of the Tax Court to "adequately distinguish" the instant case from *Wilcox* is that (R. 28a):

> "* * * there need be little fear here as there was in the *Wilcox* case that 'Sanctioning a tax * * * would serve only to give the United States an unjustified preference as to part of the money which rightfully and completely belongs to the taxpayer's employer.' Petitioners are obviously in a financial position to make good such defalcations, if any, as their associates decide to recover",

after which the Tax Court concluded, "There was hence no error in the determination of deficiencies against petitioners * * *." The Court of Appeals (R. 142) terms this obviously unlawful conclusion of the Tax Court as "another relevant distinction between this case and *Wilcox*," and respecting the Tax Court's conclusion that "Petitioners are obviously in a financial position to make

good such defalcations, if any, as their associations decide to recover", appends a footnote to its Opinion (R. 142) that, "Petitioners dispute this finding but refer us to no contrary proof." As the Dissenting Opinion of the Court of Appeals properly declares (R. 148), "* * * utterly irrelevant to the issue as to whether the Kanns embezzled the money, was the question as to whether or not they could repay it." In addition, there is nothing in the record to substantiate what the Court of Appeals terms the "finding" of the Tax Court that petitioners are obviously in a financial position to make good such defalcations, if any, as their associates decide to recover. The record (R. 52a-55a, 60a-61a, 76a-84a, 85a-90a, 111a-116a) shows that up to the date of trial the companies had recovered parts of the embezzled funds and PCS held as collateral on the obligations of the Kanns to it arising out of the embezzlements all of the shares of stock of PCS owned by G. H. and W. L. Kann. Aside from the question of the relevancy of the Kanns' ability to repay the embezzled funds, the record shows that three stockholders of the company, including a brother of the Kanns, (Supp. Stip. Par. 21, Ex. 17-Q, p. 143, R. 50a) were of opinion in August, 1948, that the prospects of the Kanns' indebtedness or any appreciable part thereof being paid then or in the near future "were practically negligible."

After agreeing with the Tax Court in its improper conclusion as above, the Court of Appeals (R. 142), states that it agrees "with Respondent that if Wilcox is to be limited to its facts this aspect [financial ability to repay the embezzlements] assumes considerable stature." Petitioners submit that the Supreme Court in the *Rutkin* case, in limiting the *Wilcox* case "to its facts" had refer-

ence only *to those facts* which showed that the funds involved *were embezzled* rather than, as in the *Rutkin* case, obtained *through extortion.* Certainly, it was never the intent of this Court that before the principle of Wilcox that embezzled funds were not taxable income was to be applied that the facts in the case to which it was endeavored to be applied had to match, fact for fact, those in Wilcox. Petitioners submit it was the intent and purpose of this Court in its declaration in *Rutkin* limiting the *Wilcox* case "to its facts" that if "the facts" in a particular case *showed embezzlement under the laws of the State in which the funds were stolen,* the principle of the *Wilcox* case applied. And, petitioners further submit, in the Tax Court's failing to apply that principle to the instant case it committed reversible error, and the Court of Appeals, in affirming the Tax Court, committed the same error and thus its decision conflicts with that of this Court in *Wilcox.*

As to Error 4 above: The conclusion of the Court of Appeals that Rutkin overruled Wilcox is clearly erroneous.

As stated in the Dissenting Opinion of the Court of Appeals in the instant case (R. 145), "The plain import of the majority's position is that it construed *Commissioner v. Wilcox* to have been overruled by *Rutkin v. United States.*" The Judge who wrote the Dissenting Opinion does not believe that it did, nor do petitioners. They reiterate the statements of the Dissenting Opinion on this phase appearing on pages 145 and 146 of the Record herein and in addition thereto submit that an analysis of the decision of this Court in *Rutkin* shows that it clearly distinguished its decision there from that in *Wil-*

cox and that there was clearly *no intention* on the part of this Court in its decision in *Rutkin* to, nor did it therein, overrule *Wilcox*.

In the Court of Appeals' endeavor to distinguish the instant case from *Wilcox* and to affirm the application by the Tax Court of "the Rutkin principle" to this case, it stated that (R. 138), "A review of the authorities does indeed reveal what appears to be a conflict of views." It then touched upon the decision of this Court in *North American Oil Consolidated v. Burnet,* 286 U.S. 417, wherein the Court laid the foundation for determining when income is received and when it was required to be reported for the tax purposes involved, this Court there laying down the rule that:

> "If a taxpayer receives *earnings* under a claim of right, and without restriction as to its disposition, he has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money and even though he may still be adjudged liable to restore its equivalent."

The Court of Appeals then states (R. 138) that, "Although the North American Oil case did not purport to hold that there *must* be a claim of right before there can be taxable income, the *Wilcox* case, citing North American Oil, did so state." In the most recent decision of this Court dealing with the "claim of right" theory of income which counsel for petitioners have been able to find, namely, *Healy, et al. v. Commissioner,* 345 U.S. 278 (1953), the Court, through Mr. Chief Justice *Vinson,* stated:

> "The phrase 'claim of right' is a term known of old to lawyers. Its typical use has been in real prop-

> erty law in dealing with title by adverse possession, where the rule has been that title can be acquired by adverse possession only if the occupant claims that he has a right to be in possession *as owner*. The use of the term in the field of income taxation is analogous. There is a claim of right when funds are *received* and treated by a taxpayer as *belonging to him*. The fact that subsequently the *claim* is found to be invalid by a Court does not change the fact that the *claim* did exist. A *mistaken claim* is nonetheless *a claim, United States v. Lewis,* 340 U.S. 590 (1951)." (Emphasis supplied.)

In a footnote to its Opinion in *Healy* this Court stated:

> "14. The rule announced in *North American Oil v. Burnet, supra, requires a receipt* without 'restriction on use' *as well as under a claim of right.*" (Emphasis supplied.)

The Court of Appeals, after quoting from the *North American* case (R. 138) and setting forth statements of some of the facts in the *Wilcox* case and stating that (R. 139) "While noting that it was immaterial whether the taxpayer's motive [in Wilcox] in acquiring the money was reprehensible or the mode of receipt illegal" the Supreme Court nevertheless stated (R. 139), "For present purposes" it was enough to note that "a taxable gain" is conditioned upon "(1) the presence of a claim of right to the alleged *gain* and (2) the absence of a *definite, unconditional obligation* to repay or return that which would otherwise constitute *"a gain"*, and that "without some *bona fide* legal or equitable *claim,* even though it be contingent or contested in nature, the taxpayer cannot be

said to have received any *gain* or *profit* within the reach of Section 22(a)." And then this Court said:

> "It is obvious that the taxpayer in this instance, in embezzling the $12,748.60, received the money without *any semblance of a bona fide claim of right.* And he was *at all times* under an unqualified duty and obligation to repay the money to his employer. * * * All right, title and interest in the money rested with the employer." (Emphasis supplied).

This Court thus clearly said in *Wilcox* and reiterated in *Healy* that there is a claim of right when funds *are received* and treated by a taxpayer as *belonging to him,* and though subsequently the claim is found to be invalid by a court that does not change the fact the claim did *exist,* because a *mistaken* claim is nonetheless a claim.

Turning now to *Rutkin,* the reasoning of the Court of Appeals for the Third Circuit when it decided that case (189 F. (2d) 431) was that Rutkin, who extorted funds on the basis of an alleged interest in a business venture, *received* the money with a "semblance" of a *bona fide claim of right,* and, there being *no* definite, unconditional obligation *to return the money,* he was required to report such funds as taxable income. Thus, that Court concluded that Rutkin had *received* the funds *and treated them* "as belonging to him." (*Healy, supra.*)

But the Court of Appeals in its Opinion in the instant case (R. 139) when treating of the decision of the Supreme Court in *Rutkin* is of opinion that "the majority of the Court *would seem* to have discarded the claim of right test in holding that money extorted under death threats was income within Section 22(a)." Clearly, an analysis

of this Court's opinion in that respect shows otherwise and that it was of opinion Rutkin had "received and treated" the funds "as belonging to him" and thus under a "claim of right". (*Healy, supra.*)

After setting forth in its Opinion somewhat in detail the facts respecting the claims, demands and threats made of and against one Reinfeld by Rutkin, the Opinion of this Court states:

> "* * * Finally, on May 11, 1943, in New Jersey, Reinfeld paid petitioner $250,000.00 in cash.
>
> "Throughout this melodrama petitioner asserted that he was entitled to the payments he demanded from Reinfeld because of petitioner's alleged former interest in Brown Vintners Company. That interest never was identified by petitioner. Reinfeld and others testified positively that petitioner never had any such interest. Nevertheless, on May 11, Reinfeld handed to petitioner $250,000.00 in cash at the same time that Reinfeld paid $358,000.00 to Zillman and Stacher representing their conceded interest in the proceeds of Brown Vintners stock. Petitioner, with Zillman and Stacher, thereupon signed a 'general release'. It did not state the amounts paid but it did purport to release Reinfeld, Brown Vintners Company and others *from all claims* the signers had against them." (Emphasis supplied.)

The Supreme Court then stated that under the jury's verdict it accepted "the fact to be that petitioner had *no basis* for this claim to this $250,000 and that he obtained it by extortion," and "It remains for us to determine the legal issue of whether money obtained by extortion is taxable to the extortioner under § 22(a)."

Following that, *and immediately before the quotation from the Supreme Court's Opinion appearing in Court of Appeals' Opinion* (R. 140), the Supreme Court stated:

> "Under the instructions to the jury, extortion *here meant* that the $250,000 *was paid* to petitioner *in response to his false claim* thereto, his harassing demands therefor and his repeated threats to kill Reinfeld and Reinfeld's family unless the payment were made. Petitioner was unable to induce Reinfeld to believe petitioner's *false* and fraudulent *claims* to the money to be true. He induced Reinfeld to consent to pay the money by creating a fear in Reinfeld that harm otherwise would come to him and to his family. Reinfeld thereupon *delivered his own money* to Petitioner. Petitioner's *control* over the cash *so received* was such that, *in the absence of Reinfeld's unlikely repudiation of the transaction and demand for the money's return* Petitioner would enjoy its use fully as though *his title* to it were unassailable." (Emphasis supplied.)

Then follow the few lines quoted from this Court's Opinion in the Opinion of the Court of Appeals (R. 140) that:

> "An unlawful *gain,* as well as a lawful one, constitutes taxable income when its recipient has such control over it that as a practical matter, he derives readily realizable economic value from it,"

after which follow the statement which *coupled with those above set forth* clearly show that this Court in *Rutkin* was not overruling *Wilcox* or the *North American Oil* case but rather affirming its determinations of

what did not and did constitute taxable income, when it stated:

> "* * * *That occurs* when cash, *as here* is *delivered by its owner* to the taxpayer *in a manner* which allows the recipient freedom to dispose of it at will, even though it may have been *obtained by fraud* and his freedom to use it may be *assailable* by someone with *a better title* to it." (Emphasis supplied.)

In the *North American Oil* case this Court had said (R. 138):

> "They [the 1916 profits] became income of the company in 1917 when it first *became entitled* to them *and* when it *actually received* them." (Emphasis supplied.)

But in *Wilcox* this Court concluded that the embezzler received the money "without *any semblance* of a bona fire *claim of right*" and was *"at all times* under an *unqualified duty and obligation to return the money* to his employer", *in whom* "all right, title and interest in the money rested * * *." The embezzler *got no title and had no gain.* In *Rutkin,* this Court said, "Under the instructions to the jury, *extortion here meant* that the $250,000 was paid to petitioner *in response to his false claim* thereto * * *"; further, that when Reinfeld delivered his *own* money to Rutkin the latter's *control over it* in the absence of Reinfeld's *unlikely* repudiation of the "transaction" and a demand for its return was such as to permit of Rutkin's enjoying it as fully as though *"his title"* were unassailable. Thus, this Court concluded that Rutkin under the facts there was "in possession as owner" *(Healy, et al., supra),* which pos-

session as owner "may be assailable by someone with a better title, "with the only *other* person *having that "better title"* being "unlikely" to repudiate *the transaction and demand* the money's return.

Thus, petitioners submit, even if in *Rutkin* the majority of this Court, in the opinion of the Court of Appeals, "would seem to have discarded the claim of right test," as a matter of *fact* and *law* it did not do so, as is clearly shown above and by its statements in *Healy, supra,* that:

> "* * * There is a claim of right when funds are *received and treated* by a taxpayer *as belonging* to him. The fact that subsequently the claim is found *to be invalid* by a Court does not *change the fact* that the claim *did* exist. A *mistaken* claim is nonetheless a claim, *United States v. Lewis,* 340 U.S. 590 (1951)." (Emphasis supplied.)

And that reasoning, petitioners submit, is the reasoning of this Court in the *Rutkin* case, as well as in the *Wilcox* and *North American Oil* cases, *none* of which are in conflict.

As to Error 5 above: The conclusion of the Court of Appeals that the instant case is controlled by Rutkin and not by Wilcox is clearly erroneous.

In its Opinion (R. 138) the Court of Appeals states that the Tax Court, "conceding the difficulty of reconciling the embezzlements in the Wilcox case, which had been held not to constitute income, and the extortion in Rutkin * * *, which did, decided that the latter case was more nearly applicable to the situation before it * * *" and holds (R. 140) that the Tax Court "cor-

rectly held the instant case to be controlled by Rutkin, not Wilcox, *particularly in view of the gloss put on the Wilcox case by the Rutkin decision.*" (Emphasis supplied.)

The Tax Court in its Opinion made not the slightest effort to show why "the Rutkin principle" was applicable to the instant case, contenting itself rather with an attempt to show why the *Wilcox* case was *not* applicable.

Petitioners submit that in the discussions of their positions above they have clearly shown that the Tax Court committed reversible error (1) in failing "to find as a fact that the Kanns had without any bona fide claim of right, fraudulently taken and converted to their own use money belonging to PCS and GSA" and (2) in failing "to find as a matter of law that the Kanns' conduct constituted embezzlement and that under the Wilcox decision the moneys which they had embezzled were not taxable income" (Dis. Op. R. 150) and that the Court of Appeals in affirming the Tax Court committed clear-cut mistakes of law as above set forth. Petitioners have not, however, treated above of the gloss which "particularly" led the Court of Appeals to conclude that the instant case was "controlled by Rutkin, not by Wilcox."

In its Opinion in the *Rutkin* case this Court after stating that, "There has been a wide-spread and settled administrative and judicial recognition of the taxability of unlawful gains of many kinds under Section 22(a)" then, under footnotes 8 and 10 cites the "gloss" to which the Tax Court apparently had reference, which cover cases where money was paid to a political leader as pro-

tection against police interference with gambling; where money was paid through illicit traffic in liquor; where money was paid to racketeers for protection and ransom paid to a kidnapper; graft payments; bribes; moneys received for writing unlawful insurance contracts; black market gains; moneys received through lotteries, from unlawful prize fight pictures, race track bookmaking and swindling; after which this Court in its Opinion continued:

> "* * * The application of this Section to unlawful gains is obvious from its legislative history. * * *
>
> "There is little doubt now that where unlawful gains are secured by the fraud of the taxpayer they are taxable. [Citing a swindling case]. In the instant case it is not questioned that the $250,000 would have been taxable to petitioner if he had obtained it by fraudulently inducing Reinfeld to believe petitioner's false claims to be true. That being so, it would be an extraordinary result to hold here that petitioner is to be tax free because his fraud was so transparent that it did not mislead his victim and his victim paid him the money because of fear instead of fraud.
>
> "We do *not* reach in this case *the factual situation* involved in *Commissioner v. Wilcox,* 327 U.S. 404. We limit that case to its findings. There embezzled funds were held not to constitute taxable income to the embezzler under Section 22(a). The issue here is *whether money extorted from a victim with his consent induced solely by harassing demands and threats of violence* is included in the

definition of gross income under Section 22 (a)." (Emphasis supplied).

An examination of the cases thus cited by this Court shows clearly this Court's citation of such cases was not intended in any way to change the principle which it had laid down in Wilcox *and was affirming in Rutkin* that embezzled funds were *not* taxable income. Petitioners submit this Court by its citation of those cases clearly distinguished all of them and its reasoning therein from *Wilcox,* and brought the *Rutkin* case within the ambit of those decisions. In each and every one of those cases the funds involved were "received and treated by the taxpayer as belonging to him" as *owner* and *thus under a claim of right.* The Courts in those cases thus held the funds were "gains". But in *Wilcox* this Court said that, "without some bona fide legal or equitable claim, * * * the taxpayer cannot be said to have received *any gain or profit* within the reach of Section 22(a)." The fact that the moneys in all of these cases were derived from illegal or unlawful activities was, correctly, of no consequence. In each of the cases included in this Court's gloss in the *Rutkin* case there was the delivery of funds by the party who then owned them to a person (the taxpayer in each case) who *received and treated the funds* "as belonging to him," (*Healy, supra*), but in the *Wilcox* case *and the instant case* there was neither *the delivery* of funds *by the owner* thereof nor *the receipt* of those funds by the embezzler "as belonging to him." In *Wilcox and the instant case* there was action by only one party, and that was the fraudulent and surreptitious taking possession of the funds by the embezzler not "as owner" but as a thief, immediately and at all times thereafter "under an

unqualified duty and obligation to repay the money" to *its owner,* in whom "All right, title and interest" *therein* rested. (*Wilcox, supra.*)

Clearly, petitioners submit, "the gloss put on the Wilcox case by the Rutkin decision" serves not to overrule or even to narrow *but to clearly affirm* the "embezzlement funds" principle of *Wilcox* and to show "the Rutkin principle" as one laid down by the Courts long since and merely again reiterated and invoked in that case.

As to Error 6 above: The conclusion of the Court of Appeals that Stella H. Kann filed joint income tax returns with her husband, W. L. Kann, for the years 1937 and 1938 is clearly erroneous, because it is in conflict with the decision of the Court of Appeals for the Third Circuit in McCord v. Granger, supra.

In affirming the Tax Court that joint returns were filed by W. L. and Stella H. Kann for the years 1937 and 1938 the Court of Appeals concluded that the Commissioner's regulations requiring that joint returns of husband and wife must be signed by both spouses, except that one spouse may sign the return as agent for the other, if the return is accompanied by a power of attorney authorizing such action "are not mandatory but merely set forth a method of compliance and may be waived by the Commissioner", and that "the Tax Court having found as a fact that joint returns were filed we cannot say that this determination was clearly erroneous." (R. 143).

The Dissenting Opinion herein disagrees with the conclusion of the majority on this issue (p. 14), citing

in support of taxpayer's position that joint returns were not filed the decision of the Court of Appeals for the Third Circuit in *McCord v. Granger, supra.* In that case the Judge writing the Dissenting Opinion in the instant case and two Judges other than those who represent the majority opinion in this case, in considering and passing upon Section 29.51-1 of the Commissioner's Regulations (similar to those herein involved) *requiring signatures of both spouses for a joint return,* concluded that such Regulations were not *merely* to safeguard the Commissioner against the claims of non-signing spouses, *may not be waived,* and are binding upon the government as well as the taxpayer.

We submit that this intra-Circuit conflict of decision of *three* Judges of the Court of Appeals for the Third Circuit in that case should be resolved with the decision of *two* members of that Court in the instant case, and the determination here reversed.

As to Error 7 above: The conclusion of the Court of Appeals that Stella H. Kann absent a showing of fraud as to her is liable for 1937 and 1938 fraud penalties is clearly erroneous, because it completely ignores the provisions of Section 1112 of the Internal Revenue Code placing the burden of proof on the Commissioner to establish the presence of "fraud with intent to evade tax" and is in conflict with the decision of the Court of Appeals for the Third Circuit in Maddas v. Commissioner, supra, and the decisions of other Courts of Appeals.

The Court of Appeals concluded that absent a showing of fraud as to petitioner Stella H. Kann she is liable for the 1937 and 1938 fraud penalties determined by the

Tax Court. The Dissenting Opinion of the Court of Appeals in the instant case disagrees with the majority as to this determination, stating that even if the returns for 1937 and 1938 were joint there is no liability on the part of Stella H. Kann "for a fraud penalty since the government failed to discharge its affirmative burden of proof with respect to any fraudulent intent on her part to evade tax." (R. 150).

In support of its conclusion, the majority opinion here cites three cases and quotes from a House of Representatives' Report on the Revenue Act of 1938, but, petitioners submit, neither the cases cited nor the quotation from the House Report deal with the question of intent and the burden placed upon the Commissioner to prove intent to evade. In the *Moore* case (37 F. Supp. 136, 1941) fraud penalties were not involved and the *Boyett* and *Howell* cases (204 F. (2d) 205, 5th Cir. 1953, and 175 F. (2d) 240, 6th Cir. 1949) did not reach the question of the Commissioner's burden to prove intent to evade. All the House Report said was that, "The *spouses* who *exercise the privilege* of filing a joint return, are jointly and severally liable *for the tax computed upon their aggregate income,*" the Report further stating that, "It is necessary, for administrative purposes, that any doubt as to the existence of *such liability* should be set at rest, if the privilege of filing such joint returns is continued." That Report said nothing in its comments on Section 51(b) of the Bill respecting any liability for fraud penalties, which under Section 293 of the 1938 Revenue Act, as well as the 1936 Revenue Act, were specifically designated as "additions" *to the tax* in case of deficiency.

The Tax Court did not make any Finding of Fact that petitioner Stella H. Kann filed income tax returns for the years 1937 and 1938 which were false or fraudulent with intent to evade tax. It did find that the failure of petitioners W. L. Kann and Gustave H. Kann to have included "in their respective income tax returns for the years 1936 to 1941, inclusive," certain dividends received by such petitioners from Steelblast Abrasives Company "was due to fraud with intent to evade tax" (R. 20a, 21a), this having been stipulated (R. 33a, 34a).

In its Opinion all the Tax Court said with respect to "fraud penalties" against petitioner Stella H. Kann was that since it had found "as a fact" that the returns in question were the joint returns of herself and her husband, that finding "is dispositive of the question," and that "This applies to the fraud penalties as well as to the deficiencies, whether or not the wife was a party to the fraud." (R. 28a).

In support of this conclusion the Tax Court merely cites the case of *Myrna S. Howell, supra.* There the taxpayer conceded liability, and the question here involved was not there at issue.

After stating that "There is no distinction in this respect between the years 1937 and 1938" (R. 28a) and citing the *Howell* and *Manton* cases, (R. 29a) the Tax Court states, "The fact then that the returns were joint imposes a liability on the wife for the earlier year to the same extent as for the later." (R. 29a). This is *the exact opposite* of that which the same Judge of the Tax Court stated in the *Manton* case, *supra,* where the Court held that income tax returns for the years 1935, 1936 and 1937 designated "joint returns", but signed only by the hus-

band without authorization by or knowledge of the petitioner wife who had no income or deductions in the taxable years, were not joint returns and did not create any liability upon petitioner for deficiencies and fraud penalties determined against the husband, the Court stating:

> "* * * we *never reached the principle* which respondent seeks to invoke, that a wife was jointly and severally liable with her husband *even before 1938* for the tax due upon a joint return and possibly also for the penalties for fraud, * * * in the filing of such return * * *."

While the Revenue Act of 1938 for the first time provided that the liability "with respect to the tax" on the return filed jointly by a husband and wife "shall be joint and several", Section 51(b) made no reference whatever to Section 293 of the Act covering additions to the tax in case of deficiency. Sub-section (b) thereof merely provided that "If any part of any deficiency is due to fraud with intent to evade tax, then 50 per centum of the total amount of the deficiency (in addition to such deficiency) shall be so assessed, collected and paid, * * *."

Where the Commissioner asserts a fraud penalty as an addition to a deficiency which he has determined to be due, then under Section 1112 of the Internal Revenue Code (derived from Section 907(a), of the Internal Revenue Act of 1924, as amended by Section 601 of the Internal Revenue Act of 1928) the burden of proof is on him to establish the presence of "fraud with intent to evade tax", which alone justifies the imposition of the fraud penalty. This is an affirmative burden of proof, as fraud is never presumed and must be proved not by any mere

preponderance of evidence but clearly and convincingly. ***Frank A. Maddas,*** 40 B.T.A., 572, Aff'd. 114 Fed. (2d) 548 (C.C.A. 3d 1940).

The issue of fraud on the part of petitioner Stella H. Kann was raised through the Petition, Commissioner's Answer and the Reply. While said petitioner responded to the subpoena of Commissioner and was present in Court during the trial of these cases, the Commissioner made no effort to call her or any other witnesses to prove that she was guilty of fraud in connection with the returns for the years 1937 and 1938 in evidence and signed only by her husband. The Commissioner contented himself merely with the introduction of the returns in question by stipulation.

Petitioner Stella H. Kann submits that the determination of the Court of Appeals on this issue is in conflict not only with Section 1112 of the Internal Revenue Code and that Court's decision in ***Maddas v. Commissioner,*** 114 F. (2d) 548, but as well in conflict with ***Kenny, et al. v. Commissioner,*** 111 F. (2d) 374 (C.C.A. 5th); ***Budd v. Comm.,*** 33 F. (2d) 509 (C.C.A. 3d), reversing 12 B.T.A. 490; ***Joseph Calafato, et al,*** 42 B.T.A. 881, Aff'd. *per curiam,* 124 F. (2d) 187 (C.C.A. 3d); ***Henry S. Kerbaugh,*** 29 B.T.A. 1014, Aff'd. 74 F. (2d) 749 (C.C.A. 1st), and is clearly erroneous in law and should be reversed.

Conclusion.

For all of the reasons above stated, the Court of Appeals erred in affirming the Tax Court and this Petition for a Writ of Certiorari should accordingly be granted.

Respectfully submitted,

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March, 1954.

APPENDIX.

Revenue Act of 1936 (Applicable to taxable years 1936 and 1937), 49 Stat. 1648, Ch. 690:

"SEC. 22. GROSS INCOME.

"(a) General definition. — 'Gross income' includes gains, profits, and income derived from * * * dividends, securities, * * * or gains or profits and income derived from any source whatever. * * *

* * * * * * *

"SEC. 51. INDIVIDUAL RETURNS.

* * * * * * *

"(b) Husband and wife.—If a husband and wife living together have an aggregate net income for the taxable years of $2,500 or over, or an aggregate gross income for such year of $5,000 or over—

"(1) Each shall make such a return, or

"(2) The income of each shall be included in a single joint return, in which case the tax shall be computed on the aggregate income.

* * * * * * *

"SEC. 115. DISTRIBUTION BY CORPORATIONS.

"(a) Definition of dividend. — The term 'dividend' * * * means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings, or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year * * * without regard to the amount of the earnings and profits at the time the distribution was made.

* * * * * * *

"SEC. 293. ADDITIONS TO THE TAX IN CASE OF DEFICIENCY.

* * * * * * *

"(b) Fraud. — If any part of any deficiency is due to fraud with intent to evade tax, then 50 per centum of the total amount of the deficiency (in addition to such deficiency) shall be so assessed, collected, and paid, * * *."

Revenue Act of 1938 (Applicable to taxable year 1938), 52 Stat. 447, Ch. 289:

SEC. 22(a). (Same as in Revenue Act of 1936, above)

"SEC. 51. INDIVIDUAL RETURNS.

* * * * * * *

"(b) Husband and wife. — In the case of a husband and wife living together the income of each (even though one has no gross income) may be included in a single return made by them jointly, in which case the tax shall be computed on the aggregate income, and the liability with respect to the tax shall be joint and several. * * *"

SEC. 115(a). (Same as in Revenue Act of 1936, above.)

SEC. 293(b). (Same as in Revenue Act of 1936, above.)

Internal Revenue Code (Applicable to taxable years 1939 to 1941, inclusive, 26 U.S.C. 1946 ed.:

SEC. 22(a). (Same as in Revenue Act of 1936, above.)

SEC. 115(a). (Same as in Revenue Act of 1936, above.)

Regulations 94, promulgated under Revenue Act of 1936 (Applicable to years 1936 and 1937):

"ART. 22(a)—1. What included in gross income. — Gross income includes * * * dividends, and gains, profits, and income derived from any source whatever, unless exempt from tax by law. * * * In general, income is the gain derived from capital, from labor, or from both combined, * * *. * * * Income may be in the form of cash or of property. As to dividends, whether in cash or in property, see section 115. * * *"

* * * * * * *

"ART. 51—1. Individual returns. — For each taxable year every single person and every married person not living with husband or wife for any part of the taxable year, whose gross income as defined in sections 22 and 116 is $5,000 or over, or whose net income as defined in section 21 is $1,000 or over, must make a return of income. * * * If the income of each is included in a single joint return, the tax is computed on the aggregate income and all deductions and credits to which either is entitled shall be taken from such aggregate income. A joint return of husband and wife may be filed only if they were living together at the close of their taxable year. If one spouse dies prior to the last day of the taxable year, the surviving spouse may not include the income of the deceased spouse in a joint return for such taxable year.

The joint return of a husband and wife (if not made by an agent other than husband or wife, see article 51-2) must be signed by both spouses, except that one spouse may sign the return as the agent for the other, if the return is accompanied by a power of attorney on Form 936, authorizing such action. The suopse acting as agent shall, with the principal, assume the responsibility for making the return and incur liability for the penalties provided for erroneous, false, or fraudulent returns.

The joint return of a husband and wife must be sworn to before an officer duly authorized to administer oaths (see article 51-4) by the spouse preparing the return. The spouse who fills in the return shall be considered to have prepared the return within the meaning of this paragraph. If the return is prepared by both spouses, or is prepared by neither spouse, then both spouses shall swear to the return, except where one spouse acts for the other spouse under a power of attorney submitted on Form 936, or the return is made by an agent by reason of illness or absence, as provided in article 51-2. * * *"

* * * * * * *

"ART. 115-1. Dividends.—The term 'dividend' * * * comprises any distribution in the ordinary course of business, even though extraordinary in amount, made by a domestic or foreign corporation to its shareholders out of either

(1) earnings or profits accumulated since February 28, 1913, or

(2) earnings or profits of the taxable year computed without regard to the amount of the earnings or profits (whether of such year or accumulated since February 28, 1913) at the time the distribution was made. * * *

A taxable distribution made by a corporation to its shareholders shall be included in the gross income of the distributees when the cash or other property is unqualifiedly made subject to their demands. * * *"

Regulations 101, promulgated under Revenue Act of 1938 (Applicable to the year 1938):

ART. 22(a)(1). (Same as in Regulations 94, above)

"ART. 51-1. Individual returns. — (a) *In general.*—For each taxable year a return of income shall be made by each citizen of the United States, * * * whether or not such citizen * * * is the head of a family or has dependents—

* * * * * * *

"(b) *Joint returns.* — A husband and wife, if living together at the close of the taxable year, may elect to make a joint return (see section 51(b)), that is, to include in a single return made by them jointly the income and deductions of each, even though one has no gross income. In such a case, the tax shall be computed on the aggregate income and all deductions and credits to which either is entitled shall be taken from such aggregate income. The liability with respect to the tax shall be joint and several. If one spouse dies prior to the last day of the taxable year, the surviving spouse may not

include the income of the deceased spouse in a joint return for such taxable year. * * *

"A joint return of a husband and wife (if not made by an agent other than husband or wife, see article 51-2) shall be signed by both spouses, except that one spouse may sign the return as the agent for the other, if the return is accompanied by a power of attorney on Form 936, authorizing such action. The spouse acting as agent shall, with the principal, assume the responsibility for making the return and incur liability for the penalties provided for erroneous, false, or fraudulent returns.

"The joint return of a husband and wife shall be sworn to before a person duly authorized to administer oaths (see article 51-4) by the spouse preparing the return. The spouse who fills in the return shall be considered to have prepared the return within the meaning of this paragraph. If the return is prepared by both spouses, or is prepared by neither spouse, then both spouses shall swear to the return, except where one spouse acts for the other under a power of attorney submitted on Form 936, or the return is made by an agent by reason of illness or absence, as provided in article 51-2. * * *"

Regulations 103, under Internal Revenue Code (Applicable to years 1939, 1940 and 1941):

ART. 22(a)—1. (Same as in Regulations 94, above.)

ART. 115—1. (Same as in Regulations 94, above.)